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Discussion of substantive issues related to international cooperation in tax matters: other issues: capacity-building

Capacity development programme in international tax cooperation

Note by the Secretariat

1. The paper contained in the annex to the present note was prepared by Eric M. Zolt, Michael H. Schill Distinguished Professor of Law, University of California Los Angeles School of Law, at the request of the Financing for Development Office of the Department of Economic and Social Affairs of the Secretariat, pursuant to Economic and Social Council resolutions 2013/24 and 2014/12. In those resolutions, the Council recognized the progress made by the Office in its work in developing, within its mandate, a capacity development programme in international tax cooperation aimed at strengthening the capacity of the ministries of finance and national tax authorities in developing countries to develop more effective and efficient tax systems that support the desired levels of public and private investment, and to combat tax evasion, and requested the Office, in partnership with other stakeholders, to continue its work in that area and to further develop its activities.

2. One of the current areas of focus of the capacity development programme is on strengthening the capacity of developing countries to increase their potential for domestic revenue mobilization by enhancing their ability to effectively protect and broaden the tax base. Tax incentives are used by Governments to attract new investment. In some cases, tax incentives have played an important role in attracting new investment that has contributed to substantial increases in growth and development. In other cases, however, tax incentive regimes have resulted in little new investment, with substantial tax base erosion. The paper annexed hereto examines the benefits and costs of using tax incentives and addresses issues in designing, granting and administering them.

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Annex

Tax incentives: benefits and costs, design and administrative considerations*

I. Introduction

1. The present paper examines the benefits and costs of using tax incentives and important considerations for designing, granting and monitoring the use of tax incentives to increase investment and growth. Tax incentives are often criticized on the grounds that they erode the tax base without any substantial effects on the level of investment. It is not easy to separate criticism of the tax incentive regimes that are currently in place from criticism of all tax incentives. Tax experts have recognized that certain well-designed tax incentives have been successful in increasing investment.

II. Benefits and costs of tax incentives

A. Benefits of tax incentives

2. If properly designed and implemented, tax incentives are a useful tool for attracting investments that would not have been made without the provision of tax benefits. Tax incentives are justified if they correct market inefficiencies or generate positive externalities. Scholars view such tax incentives as desirable, given that, without government intervention, the level of foreign direct investment would be suboptimal.[1]

3. It is not surprising that Governments often choose tax incentives over other types of action. It is much easier to provide tax benefits than to correct deficiencies in the legal system or to dramatically improve the communications system in a country. In addition, tax incentives do not require an expenditure of funds by the Government as do some alternatives, such as the provision of grants or cash subsidies to investors. Although tax incentives and cash grants may be similar in terms of their economic cost to Governments, for political and other reasons, it is easier to provide tax benefits than to actually provide funds to investors.

4. New foreign direct investment may bring substantial benefits, some of which are not easily quantifiable. A well-targeted tax incentive programme may be successful in attracting specific projects or specific types of investors at reasonable costs compared with the benefits received. The types of benefits from tax incentives for foreign investment are the benefits commonly associated with foreign direct investment, including increased capital, knowledge and technology transfers, increased employment and assistance in improving conditions in less developed areas.

5. Foreign direct investment may generate substantial spillover effects. For example, the choice of location for a large manufacturing facility will not only result

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[1] Yoram Y. Margalioth, "Tax competition, foreign direct investments and growth: using the tax system to promote developing countries", *Virginia Tax Review*, vol. 23, issue 1 (2003).

in increased investment and employment in that facility but also in firms that supply and distribute the products emanating from it. Economic growth will increase the spending power of the country's residents and that, in turn, will increase demand for new goods and services. Increased investment may also increase government tax revenue either directly from taxes paid by the investor, such as taxes paid after the expiration of the tax holiday period, or indirectly through increased tax revenue received from employees, suppliers and consumers.

6. The positive view of the benefits of foreign direct investment has recently been challenged by those who question whether tax incentives actually increase the level of foreign direct investment and whether foreign direct investment actually generates economic growth that is beneficial to development.[2] In this view, even if tax incentives succeed in attracting new investment, it is not clear, with many types of foreign investments, whether the developing country benefits.

7. Although a general description can be provided of the possible types of benefits from the additional investment that results from tax incentives, it is difficult to quantify them with any degree of certainty and, at times, benefits accrue to persons other than the firm receiving the tax benefits.

B. Costs of tax incentives

8. In considering the costs of a tax incentive regime, it may be useful to examine four different types of costs: (a) revenue costs; (b) resource allocation costs; (c) enforcement and compliance costs; and (d) the costs associated with corruption and lack of transparency.[3]

Revenue costs

9. The tax revenue losses from tax incentives come from two primary sources: forgone revenue from projects that would have been undertaken even if the investor did not receive any tax incentives and lost revenue from investors and activities that improperly claim incentives or shift income from related taxable firms to those qualifying for favourable tax treatment.

10. Policymakers seek to target tax incentives to achieve the greatest possible benefits for the lowest cost. The ideal scenario would be to offer tax incentives only to those investors at the margin who would invest elsewhere but for the tax incentives. Offering tax incentives to those investors whose decisions to invest are not affected by the proposed tax benefit merely results in a transfer to the investor from the host Government without any gain. It is very difficult to determine on a project-by-project basis which ones were undertaken solely due to tax incentives, much as it is difficult to estimate for an economy as a whole what the levels of investment would be with or without a tax incentive regime.

11. For those projects that would not have been undertaken without tax incentives, there is no real loss of tax revenue from those firms. To the extent that the firms

[2] Yariv Brauner, "The future of tax incentives for developing countries", in *Tax, Law and Development*, Yariv Brauner and Miranda Stewart, eds. (Cheltenham, United Kingdom of Great Britain and Northern Ireland, Edward Elgar Publishing, 2014).

[3] Howell H. Zee, Janet Gale Stotsky and Eduardo Ley, "Tax incentives for business investment: a primer for policymakers in developing countries", *World Development*, vol. 30, No. 9 (2002).

become regular taxpayers or that their operations generate other tax revenue, such as increased profits from suppliers or increased wage taxes from employees, there are revenue gains from those projects.

12. An additional revenue cost of tax incentives results from the erosion of the revenue base due to taxpayers abusing the tax incentive regimes to avoid paying taxes on non-qualifying activities or income. This can take many forms. Revenue losses can result when taxpayers disguise their operations to qualify for tax benefits. For example, if tax incentives are available only to foreign investors, local firms or individuals can route their local investments through foreign corporations; or if tax benefits are available only to new firms, taxpayers can reincorporate or set up many new related corporations to be treated as a new taxpayer under the tax incentive regime.

13. Other leakages occur when taxpayers use tax incentives to reduce their tax liability from non-qualified activities. For example, when a firm qualifies for a tax holiday because it is engaged in a type of activity that the Government believes merits tax incentives, it is likely quite difficult to monitor the firm's operation to ensure that it does not engage in additional non-qualifying activities. Even for cases in which the activities are separated, it is very difficult to monitor related-party transactions to make sure that income is not shifted from a taxable firm to a related one that qualifies for a tax holiday.

Resource allocation costs

14. If tax incentives are successful, they will cause additional investment in sectors, regions or countries that would not otherwise have occurred. On the one hand, the additional investment will occasionally correct for market failures; on the other hand, the tax incentives may cause allocation of resources that could result in too much investment in certain activities or too little investment in other non-tax favoured areas.

15. It is difficult to determine the effects of tax provisions in countries where markets are relatively developed. It is even more difficult to determine the consequences of tax provisions in developing countries where the markets do not reflect the existing competitive models. As such, where markets are imperfect, it is not clear whether providing tax incentives to correct market imperfections will make markets more competitive.[4]

Enforcement and compliance costs

16. As with any tax provision, there are resource costs incurred by the Government in enforcing the tax rules and by taxpayers in complying. The cost of enforcement relates to the initial grant of the incentive and the costs incurred in monitoring compliance with the qualification requirements and enforcing any recapture provisions upon termination or failure to continue to qualify. The greater the complexity of the tax incentive regime, the higher the potential enforcement and compliance costs. Tax incentive schemes that have many beneficiaries are also more difficult to enforce than narrowly targeted regimes.

[4] Richard George Lipsey and Kelvin Lancaster, "The general theory of second best", *Review of Economic Studies*, vol. 24, No. 1 (1956-1957).

17. It is difficult to motivate revenue authorities to spend resources monitoring tax incentive schemes. Revenue authorities seek to use their limited administrative resources to improve tax collection, so it is not surprising that they prefer auditing fully taxable firms rather than those firms operating under a tax holiday arrangement.

Costs associated with corruption and lack of transparency

18. Corruption can constitute a major barrier to foreign investment in a country but it does not, however, prevent foreign investors from benefiting from a corrupt system. In recent years, scholars have focused on the corruption and other rent-seeking behaviour associated with the granting of tax incentives. Several different policy approaches exist for designing the qualification requirements for tax incentives. Policymakers can choose between approaches that are automatic and objective or those that are discretionary and subjective. The opportunity for corruption is much greater for tax incentive regimes in which officials have a large amount of discretion in determining which investors or projects receive favourable treatment. The potential for abuse is also greater in cases in which no clear guidelines exist for qualification.

19. The International Monetary Fund, the Organization for Economic Cooperation and Development (OECD) and the World Bank have projects that try to reduce corruption and provide assistance to countries to establish anti-corruption programmes.[5] One element of such programmes should be the monitoring of foreign investment projects and particularly the granting of investment incentives. If a tax incentive is found to have been improperly obtained, the attendant privileges should be withdrawn and any tax that has been avoided should be repaid, in addition to any other legal sanctions.

Estimates of the costs of tax incentives

20. Even when tax incentives succeed in attracting investment, the costs of the incentives may exceed the benefits derived from the new investment. This is difficult to substantiate, since problems exist with regard to estimating the costs and benefits of tax incentives. One method of cost-benefit analysis is to estimate the cost in terms of forgone revenue and/or direct financial subsidies for each job created. Studies using that approach may not provide a true measure of efficiency, because they measure only the cost, and not the value, of the jobs created. The cost of jobs varies widely according to the country and the industrial sector, and the more "expensive" jobs may bring with them greater spillover benefits, such as technology transfer.

21. All revenue estimates are based on a set of assumptions about the responses of taxpayers to particular tax law changes. In assessing the performance of tax incentive schemes, the objectives are to determine the amount of incremental

[5] See Organization for Economic Cooperation and Development (OECD), United Nations Office on Drugs and Crime and World Bank, Anti-Corruption Ethics and Compliance Handbook for Business; Asian Development Bank and OECD, Anti-Corruption Initiative for Asia and the Pacific. Available from www.oecd.org/site/adboecdanti-corruptioninitiative; Vito Tanzi, "Corruption around the world: causes, consequences, scope and cures", *Staff Papers, International Monetary Fund*, vol. 45, No. 4 (December 1998).

investment resulting from tax incentives and the costs and benefits associated with attracting that investment.

22. Those objectives require that assumptions be made about: (a) the amount of investment that would have been made without the tax incentive programme; (b) the amount of leakage from the tax base due to taxpayers improperly claiming the tax incentives or shifting income from taxable to related tax-exempt or lower-taxed entities; and (c) the tax revenue gained from the activities, undertaken after the incentive expires, of taxpayers who were granted a tax incentive or from those activities generating other sources of tax revenue.

23. Two methods for increasing the accountability and transparency of tax incentives are implementing tax incentive budgets and analysing general tax expenditure. As discussed below, in many countries the tax authorities do not have sole responsibility or discretion in designing and administering tax incentive programmes. In those countries, different government agencies, such as foreign investment agencies or ministries of economy, have a role in designing investment regimes, approving projects and monitoring investments. Their major objective is to attract investments; they are often less concerned with protecting the tax base.

24. An approach that merits consideration is setting a target monetary amount of tax benefits to be granted under a tax incentive regime, which would require both the tax authorities and other government agencies to agree on both a target amount and a methodology for determining the revenue costs associated with a particular tax incentive regime.

25. Another method is to include tax incentives in a formal tax expenditure budget. All OECD countries and several other countries require estimates to be prepared on the revenue impact of certain existing and proposed tax provisions. The goal of those budgets is to highlight the consequences for revenue of providing tax benefits. That approach seeks to treat tax expenditure in a manner similar to direct spending programmes and thus effectively equates direct spending by the Government with indirect spending by the Government through the tax system. Although the scope of tax expenditure analysis goes beyond tax incentives, countries can choose to follow this approach for only certain types of tax incentives or for a broader class of tax provisions. For those countries that do not have a formal tax expenditure requirement, it is advised that they undertake the exercise to decide whether to adopt or retain a tax incentive regime.[6]

III. Design considerations for tax incentives

A. Eligibility issues

26. Tax incentives are departures from the benchmark system that are granted only to those investors or investments that satisfy prescribed conditions. These special tax privileges may be justified only if they attract investments that are both particularly desirable and that would not be made without such tax benefits. The first question to answer when designing a tax incentive system is what types of investment the incentives are intended to attract.

[6] Sebastian James, "Effectiveness of tax and non-tax incentives and investments: evidence and policy implications" (Washington, D.C., World Bank Group, September 2013).

Targeting incentives

27. Incentives may be broadly targeted, aiming at all new investment, foreign or domestic, or they may be very narrowly targeted, designed for one particular proposed investment. The targeting of incentives serves two important purposes: (a) it identifies the types of investment that host Governments seek to attract; and (b) it reduces the cost of incentives because it reduces the number of investors that benefit.

28. The concept of targeting incentives raises the questions of whether a Government should treat some types of investment as more desirable or beneficial than others; and whether a Government should seek to attract tax incentives and target them at particular types of investments or decide that investment decisions should be left solely to market forces. Justifiable doubt exists about the ability of politicians to choose winning investors, particularly in countries where markets are less than perfect. Furthermore, there are some types of investment that, although not completely prohibited, may not deserve encouragement in the form of tax benefits. In the ideal scenario, incentives would be given only for incremental investment, that is, for investments that would not otherwise have occurred but for the tax benefits.

29. An initial question is whether the granting of tax incentives should be discretionary or automatic, once the prescribed conditions are met. In many cases it may be advisable to limit discretion, but if qualification for incentives is made largely automatic, it would be necessary for the qualifying conditions to be elaborated clearly and in detail.

30. Many countries grant preferential tax treatment to certain sectors of the economy or to certain types of activities. Sectoral targeting has many advantages, such as restricting the benefits of the incentives to those types of investment that policymakers consider to be most desirable and making it possible to target those sectors that are most likely to be influenced by tax considerations. Among the sectors of the economy and types of activities commonly preferred are manufacturing activities and pioneer industries, as well as export promotion, locational incentives and investments that result in significant transfers of technology.

31. Countries may elect to restrict investment incentives to manufacturing activities or provide for those activities to receive preferential treatment, which is the case in China and Ireland. Such preferential treatment may reflect a perception that manufacturing is somehow more valuable than the provision of services, perhaps because of its potential to create employment, or a view that certain services tend to be more market-driven and therefore less likely to be influenced by tax considerations.

32. Some countries adopt a more sophisticated approach and restrict special investment incentives to certain broadly listed activities or sectors of the economy. Those countries can restrict tax incentives to pioneer enterprises. To be accorded pioneer status, an enterprise must manufacture products that are not already produced domestically or engage in other specified activities that are not being performed by domestic firms yet are considered especially beneficial to the host country.

33. Many countries provide tax incentives to locate investments in particular areas or regions within the country. The incentives may be provided by regional or local governments, in competition with other parts of the same country. In other cases, the incentives are offered by the central Government, often as part of its regional development policy, to promote investment in less developed regions of the country or in areas of high unemployment.

34. One benefit of foreign direct investment is the creation of new employment opportunities and, not surprisingly, incentives are frequently provided with the express intent of encouraging job creation. Policymakers could provide for tax incentives for investment in regions of high unemployment or tie the tax incentive directly to employment, with the creation of a stipulated number of new jobs as a qualifying condition for the tax holiday or other incentive.

35. Foreign direct investment often results in the transfer of technology. Even critics of tax incentives concede that they may be useful for promoting activities such as research and development, if only as a way to correct market imperfections. Countries attempt to attract technologically advanced investment in several ways: (a) by targeting incentives at technologically advanced sectors; (b) by providing incentives for the acquisition of technologically advanced equipment; and (c) by providing incentives for carrying out research and development activities.

36. The experience of many developing countries is that export promotion and the attraction of export-oriented investment is the quickest and most successful route to economic growth. It is therefore hardly surprising that competition to attract such investment is especially fierce, and investment incentives are frequently targeted at export-oriented production. Incentives targeted specifically at export-oriented investment may be more effective than other tax incentives, due to the higher degree of mobility of such investment.

Forms of tax incentives

37. The present paper examines three different types of tax incentives: tax holidays, investment credits and allowances, and tax credit accounts. Whereas the first two types of incentives are used frequently, the tax credit account approach has received too little attention from policymakers. Designing tax incentives requires a determination of the types of investment that qualify and the form of tax incentive to adopt. Tax incentives for investment take a variety of forms, the most common of which are set out in the table below.

Tax incentives worldwide

	Number of countries surveyed	*Tax holiday tax exemption*	*Reduced tax rate*	*Investment allowance tax credit*	*VAT exemption reduction*	*Research and development tax incentive*	*Super deductions**	*SEZ free zones EPZ free port*	*Discretionary process*
		Percentage							
East Asia and the Pacific	12	92	92	75	75	83	8	83	25
Eastern Europe and Central Asia	16	75	31	19	94	31	0	94	38
Latin America and the Caribbean	24	75	29	46	58	13	4	75	29

	Number of countries surveyed	*Tax holiday tax exemption*	*Reduced tax rate*	*Investment allowance tax credit*	*VAT exemption reduction*	*Research and development tax incentive*	*Super deductions**	*SEZ/free zones /EPZ/free port*	*Discretionary process*
		Percentage							
Middle East and North Africa	15	73	40	13	60	0	0	80	27
OECD countries	33	21	30	61	79	76	18	67	27
South Asia	7	100	43	71	100	29	57	71	14
Sub-Saharan Africa	30	60	63	73	73	10	23	57	47

Source: Sebastian James, "Effectiveness of tax and non-tax incentives and investments: evidence and policy implications" (Washington, D.C., World Bank Group, September 2013).

Abbreviations: VAT, value added tax; SEZ, special economic zone; EPZ, export processing zone; OECD, Organization for Economic Cooperation and Development.

* Super deductions are deductions that exceed those normally granted to taxpayers, such as depreciation at a rate which is two to three times the standard depreciation rate.

Tax holidays

38. In developing countries, tax holidays are by far the most common form of tax incentive for investment. A tax holiday may take the form of a complete exemption from profits tax and occasionally also from other taxes, a reduced rate of tax or a combination of the two, for example, two years' exemption plus a further three years at half the standard rate. The exemption or reduction is granted for a limited duration.

39. Tax holidays can vary in duration from as little as 1 year to as long as 20 years. In determining the length of the tax holiday, a clear trade-off exists between the attractiveness to investors and the revenue cost to the host country's treasury. Most studies have concluded that short tax holidays are of limited value or interest to most potential investors and are rarely effective in attracting investment, other than projects that are short-term and "footloose", or not tied to a particular location and able to relocate in response to changing economic conditions. Substantial investments often take several years before they begin to show a profit, by which time the tax holiday may have expired. Short tax holidays are of the greatest value to investments that can be expected to show a quick profit and are thus quite effective in attracting investment in export-oriented activities such as textile production. Since that sector is highly mobile, it is not uncommon, however, for a firm to enjoy a tax holiday in one country and, when it expires, move its entire operation to another country that is willing to give a new holiday. Consequently, the benefit of the investment to the host country may be quite limited.

40. Tax holidays have the apparent advantage of simplicity for both the enterprise and the tax authorities. The simplest tax holiday regime, and the most investor-friendly, provides not only that no tax is payable during the holiday period but that taxpayers are not required to file information or tax returns, which results in an absence of compliance and administrative cost. The better approach is to require the filing of a tax return during the holiday period. For example, if the enterprise is permitted to carry forward losses incurred during the holiday period or claim depreciation allowances after the end of the holiday period for expenditure incurred during the holiday, it would need to at a minimum keep appropriate records.

41. In addition, tax holidays are especially prone to manipulation and provide opportunities for tax avoidance and abuse. Another disadvantage is that the revenue cost of tax holidays cannot be estimated in advance with any degree of accuracy, nor can the cost related to the amount of the investment or to the benefits that may accrue to the host country. Furthermore, tax holidays exempt profits with no regard to the level or amount of profits that are earned. For potential investments that investors believe will earn above market returns, tax holidays will result in a loss of tax revenue without any benefits. Because of the high return, investors would have undertaken these projects even without the availability of tax incentives.[7]

Investment allowances and credits

42. As an alternative, or sometimes in addition, to tax holidays, some Governments provide investment allowances or credits. They are given in addition to the normal depreciation allowances, with the result that the investor may be able to write off an amount that is greater than the cost of the investment. An investment allowance reduces taxable income, whereas an investment tax credit is set against the tax payable, therefore, with a corporate income tax rate of 40 per cent, an investment allowance of 50 per cent of the amount invested equates to an investment credit of 20 per cent of that amount.

43. Investment allowances or credits may apply to all forms of capital investment, or they may be restricted to specific categories, such as machinery or technologically advanced equipment, or to capital investment in certain activities, such as research and development. Countries occasionally limit eligibility to contributions to the charter capital of the firm, an approach that may encourage investors to increase the relative amount of equity capital rather than related-party debt capital in the firm's initial capital structure.

44. One objection to the use of investment allowances and credits is that they favour capital intensive investment and may be less favourable towards employment creation than would tax holidays. They may also distort the choice of capital assets, possibly creating a preference for short-lived assets so that a further allowance or credit may be claimed on their replacement.

45. Investment allowances and credits seem preferable to tax holidays in almost every respect: (a) they are not open-ended; (b) the revenue cost is directly related to the amount of the investment, so there should be no need for a minimum threshold for eligibility; and (c) their maximum cost is more easily estimated. However, a recent study does find that investment credit and allowances are significantly less effective in attracting foreign investment than are tax holidays.[8]

Tax credit accounts

46. An interesting approach to offering tax benefits to potential investors that allows tax authorities to determine with great certainty the revenue costs of the tax incentive programme is to provide each qualifying investor a specific amount of tax relief in the form of a tax credit account, such as a potential exemption of $500,000

[7] Vito Tanzi and Howell H. Zee, "Tax policy for emerging markets: developing countries" (Washington, D.C., International Monetary Fund, 2000).

[8] Alexander Klemm and Stefan Van Parys, "Empirical evidence on the effects of tax incentives" (Washington, D.C., International Monetary Fund, 2009).

of corporate income tax liability.[9] The investor would be required to file tax returns and keep books and records just like any other taxpayer. If the investor determines it has $60,000 of tax liability in year one, it would pay no tax, but the amount in its tax account would be reduced to $440,000 for future tax years. The tax credit account has the advantage of providing transparency and certainty to both the potential investor and the Government.

47. The tax credit account may be regarded as a hybrid of a tax holiday and an investment tax credit. It resembles a tax holiday, except that the tax exemption period, instead of being a fixed number of years, is related to the amount of taxes due on the income earned, such as in the above-mentioned example in which the exemption applies to the first $500,000 of taxable income. There are two important advantages: the cost of the incentive to the host Government is known and there is no strong built-in advantage for those investments that make quick profits. The tax credit account resembles an investment tax credit in that the amount of the credit is a fixed sum, but it differs in that the amount is not determined by the amount of the investment and consequently does not provide a preference to capital-intensive investments.

B. Implementation issues

Initial compliance with qualifying conditions

48. Initially, it must be determined whether an investor meets the qualifying conditions. Some incentive provisions require initial approval or another positive decision. For example, officials may need to determine whether the investment is in a priority sector, if the investor will meet prescribed employment or export targets and/or comply with environmental requirements. Generally, tax authorities will require some form of written certification of qualification. Another type of qualifying condition requires a determination of the nature of the investor, such as whether: the foreign participation in a joint venture exceeds a stipulated percentage; a certain number of new jobs have been created; a particular capital investment falls within a category qualifying for accelerated depreciation; or imported equipment can be classified as advanced technology. Tax authorities sometimes carry out this verification or they can require written confirmation from the appropriate authority or department. Another type of condition requires a valuation of assets. For example, investors may be required to establish that the amount invested exceeds the minimum amount stipulated to qualify for a tax holiday or that an investment qualifies for a tax credit of a given amount.

Reporting and monitoring continuing compliance

49. Conditions are sometimes attached to incentives that are related to ongoing performance, such as requirements that, throughout the tax holiday period, a given number of jobs are maintained or a certain percentage of production is exported. Such incentives require continual monitoring. Although it imposes an additional administrative burden on authorities, it does have the merit of providing the host Government with a reasonably accurate idea of how an investment is performing. Without a formal monitoring mechanism, investors have little reason to make

[9] Vito Tanzi and Howell H. Zee, "Tax Policy for Emerging Markets" (see footnote 7 above).

realistic projections as to the number of jobs that will be created or the volume of exports that will be produced, and some studies have shown large discrepancies between investor prediction and performance. However, it is important to consider the Government's administrative capability to conduct the necessary monitoring when incentive legislation is drafted so that unnecessary supervision is avoided.

Common abuses of tax incentive regimes

50. Ongoing monitoring of investments is necessary not only to ensure continuing compliance with qualifying conditions but to detect tax avoidance or evasion. Tax avoidance presents greater difficulties, because countries have different attitudes as to what constitutes avoidance and what to do about it. For example, granting a tax holiday may be conditional upon an investor's employing a given number of people. In some countries an investor could legitimately make up the qualifying number by hiring employees with minimal duties and at low wages. In other countries, that course of action might be considered an abuse of the legislation and result in the denial or withdrawal of the tax privilege.

51. Ten of the most common abuses associated with tax incentives, some of which are elaborated upon below, are:

(a) Existing firms transforming into new entities to qualify for incentives;

(b) Domestic firms restructuring as foreign investors;

(c) Engaging in transfer pricing schemes with related entities (sales, services, loans, royalties, management contracts);

(d) Churning investments or creating fictitious investments due to lack of recapture rules;

(e) Schemes to accelerate income or defer deductions at the end of a tax holiday period;

(f) Overvaluation of assets for depreciation, tax credit or other purpose;

(g) Employment and training credits, such as fictitious employees and fake training programmes;

(h) Leakages from export zones into the domestic economy;

(i) Regional investment incentives and enterprise zones diverting activities to outside the region or zone;

(j) Disguising non-qualifying activities or burying them in qualifying activities.

Round tripping

52. Round tripping, when one company sells an unused asset to another company under the agreement that it will buy it back for the same price, typically occurs in countries where tax incentives are restricted to foreign investors or to investments with a prescribed minimum percentage of foreign ownership. Domestic investors may seek to disguise their investments to qualify for those incentives by routing their investments through a wholly controlled foreign corporation. Similar practices have occurred in a number of countries with economies in transition, especially in connection with the privatization of State-owned firms in which the existing

management has acquired ownership of the firm through the vehicle of an offshore company. Round tripping is not always undertaken in order to meet foreign ownership requirements; it may also be used to take advantage of favourable tax treaty provisions.

Double dipping

53. Many tax incentives, especially tax holidays, are restricted to new investors. In practice, such a restriction may be ineffective or counter-productive. An existing investor that plans to expand its activities will simply incorporate a subsidiary to continue the activity and the subsidiary will qualify for a new tax holiday. A different type of abuse occurs when a business is sold towards the end of the tax holiday period to a new investor who then claims a new tax holiday. Sometimes the "new" investor is related to the seller, although the relationship is concealed. A more satisfactory approach for policymakers may be to use investment allowances or credits, rather than tax holidays, so that new investments, rather than investors, qualify.

Transfer pricing

54. Transfer pricing has been described as "the Achilles heel of tax holidays",[10] although it can be a problem with other forms of investment incentives. There is a tendency to think of transfer pricing as a phenomenon that occurs internationally in transactions between related enterprises in different countries. Transfer pricing can also take place in a single country in which an investor has two or more operations or derives income from more than one activity. If one of those operations, or one type of income, enjoys a tax preference, the investor will tend to allocate profits to the preferred activity.

55. Transfer pricing is likely to take place in the following scenarios: (a) an investor undertakes two or more activities, one of which qualifies for an incentive, such as manufacturing or exporting, and another does not; (b) an investor has operations in two or more locations, one of which is in a tax-privileged region and another is not; or (c) an investor owns two or more subsidiaries, one of which enjoys a tax holiday and another does not. In each case, the investor will wish to allocate as much profit as possible to the tax-exempt or tax-privileged entity or activity. In cases (a) and (b) there may be only a single entity, in which case there is no transfer pricing as such, but an equivalent result is achieved through the allocation of revenue and expenditure.

56. Substantial challenges exist for monitoring transfer pricing, especially for small or less developed countries. One approach may be to use tax incentives that are less prone to transfer pricing abuses. For example, in contrast to tax holidays, investment allowances or credits provide an exemption from tax of a given amount, rather than for a given period, therefore artificial transfers of profits to a firm that has been granted an investment allowance or credit may result in its tax liability being postponed but not eliminated.

[10] Charles E. McLure, Jr., "Tax holidays and investment incentives: a comparative analysis", *Bulletin for International Fiscal Documentation*, vol. 53 (1999).

Overvaluation

57. Overvaluation, and sometimes undervaluation, is a constant problem in any tax system, and tax incentives may provide additional temptation to inflate the value of assets. For example, when granting a tax holiday is conditional upon a firm investing a certain minimum amount, the value of assets contributed to the new firm can be manipulated to achieve the target figure. This may be done legitimately, for example, by purchasing machinery rather than leasing it from independent lessors. In other cases, however, an inflated value is attributed to the property contributed, especially in cases of intellectual property. When investors also receive an exemption from customs duties for newly contributed capital, there is no motivation in terms of compensation for investors to correctly state the value or for customs authorities to monitor the declared value. A further problem may be encountered when foreign investment agencies have an incentive to boost their investment figures, resulting in a common interest between the agency and the investor to inflate the amount of the investment. It is thus important for the tax administration to be involved in the valuation process.

Abuse of duty-free privileges

58. A common investment incentive is an exemption from customs duty on imported equipment. Once imported, however, items may be resold on the domestic market. A partial solution is to restrict the exemption to those assets that are contributed to the charter capital of the enterprise, but it still may be necessary to verify periodically that the assets remain in the enterprise. Another approach is to restrict the exemption to assets such as machinery, which are less likely to be resold, and to exclude items such as passenger vehicles and computer equipment.

Asset stripping and "fly-by-night" operations

59. Many countries have experienced problems with "fly-by-night" operators that take advantage of tax incentives to make a quick, tax-free profit and then leave to begin operations in another country that offers tax privileges. This problem most often arises with the use of tax holidays and export processing zones. Another problem occurs when a foreign investor acquires control of an existing local enterprise and, instead of contributing new capital to modernize the enterprise, strips it of its useful assets and leaves the country. The latter problem is not necessarily linked to the availability of tax incentives, although the ability to make a tax-free capital gain is an added attraction to the investor stripping the assets.

60. Some countries have attempted to counter the fly-by-night operator problem by introducing "clawback" provisions. For example, a country can grant a tax holiday for a 5-year period only if the venture continues for a period of 10 years. If the venture is terminated before the end of the 10-year period, any tax that was foregone must be repaid. The difficulty with such a provision is that the investor may have left the country before it is possible to claw back any of the forgiven tax liability.

C. Review and sunset provisions

61. The costs and benefits of tax incentives are not easy to evaluate and are difficult to quantify and estimate. Incentives that may work well in one country or region may be ineffective in another context. Tax incentive regimes in many

countries have evolved from general tax holidays to incentive regimes that are more narrowly targeted.

62. It may therefore be advisable: (a) to limit the duration of tax incentive regimes to reduce the potential costs of unsuccessful or poorly designed programmes by including a specific sunset provision as part of the original legislation; (b) to design incentive regimes that require beneficiaries to report to investment agencies and that specify which government agency is responsible for monitoring and enforcing qualification and any recapture provisions; and (c) to require an evaluation as to the costs and benefits of specific tax incentive regimes and to specify the timing of the evaluation and the parties responsible for conducting the review.

D. Guidance for policymakers

63. No shortage exists of advice to policymakers; a relatively concise prescription on how to design and implement tax incentives is to keep them simple.[11] Attempts to fine-tune incentives to achieve detailed policy goals are likely to be costly to administer and unlikely to produce the desired result. The Government should diligently record the beneficiaries of tax incentives, their duration and the costs in forgone revenue. That information is necessary to ensure transparency and accountability. Governments must evaluate tax incentives' effectiveness in achieving the desired results and be willing to terminate or modify those incentive programmes that fail to achieve their objectives.

64. OECD has prepared a best practices guide to enhance the transparency and governance of tax incentives in developing countries.[12] The following actions by Governments are needed in order to implement the best practices:

(a) Make public a statement of all tax incentives for investments and their objectives within the governing framework;

(b) Provide tax incentives for investment through tax laws only;

(c) Consolidate all tax incentives for investment under the authority of one government body, where possible;

(d) Ensure tax incentives for investments are ratified through the law-making body or parliament;

(e) Administer tax incentives for investment in a transparent manner;

(f) Calculate the amount of forgone revenue attributable to tax incentives for investment and publicly release a statement of tax expenditure;

(g) Carry out periodic review of the continuance of existing tax incentives by assessing the extent to which they meet the stated objectives;

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[11] Richard M. Bird, "Tax incentives for investment in developing countries", in *Fiscal Reform and Structural Change in Developing Countries*, vol. 1, Guillermo Perry, John Whalley and Gary McMahon, eds. (London, United Kingdom, and Canada, Macmillan in association with the International Development Research Centre, 2000).

[12] OECD, Draft Principles to Enhance the Transparency and Governance of Tax Incentives for Investment in Developing Countries. Available from http://www.oecd.org/ctp/tax-global/transparency-and-governance-principles.pdf.

(h) Highlight the largest beneficiaries of tax incentives for investment by specific provision in a regular statement of tax expenditure, where possible;

(i) Collect data systematically to underpin the statement of tax expenditure for investment and to monitor the overall effects and effectiveness of individual tax incentives;

(j) Enhance regional cooperation to avoid harmful tax competition.

IV. Conclusion

65. Tax incentives can play a useful role in encouraging both domestic and foreign investment. The extent of their usefulness, and at what cost, depends upon how well the tax incentive programmes are designed, implemented and monitored. The present paper has examined the costs and benefits of tax incentives and the relative advantages and disadvantages of different types of incentives, as well as set out important factors to consider in designing, granting and monitoring the use of tax incentives to increase investment and growth.

66. The questions of whether to use tax incentives and what form they should take are not easy to answer. The following, however, are some clear guidelines which may improve the chances of success of tax incentive programmes: the objectives of the tax incentive programme should be clearly set forth; the type of tax incentive programme should be crafted to best fit the objective; the Government should estimate the anticipated costs and benefits of the incentive programme in a manner similar to other types of tax expenditure analysis; the incentive programme should be designed to minimize the opportunities for corruption in the granting of incentives and for taxpayer abuse in exploiting the tax benefits; the tax incentive regime should have a definite sunset provision to allow for a determination of the merits of the programme; and the Government should be required at a specific time to assess the success and failure of each incentive programme.